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Strategy update

Changes to Australian shares strategy in our MLC Inflation Plus portfolios

23 November 2016

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What changes are we making?

- Adding a defensive Australian shares strategy, managed by MLC.
- Reducing the allocations to cash and existing Australian shares managers.

"Including this new Australian shares capability in our MLC Inflation Plus portfolios is an important evolution of our strategy to achieve real return outcomes for our clients."

At MLC, we actively manage our portfolios and work constantly to improve them.

That's why we've developed a tailored defensive Australian shares strategy for our MLC Inflation Plus portfolios.

The MLC Inflation Plus portfolios target returns above inflation, regardless of what's happening in markets. We aim to achieve this by carefully managing risk, with a particular focus on limiting the risk of significant negative returns.

In the current investment environment, it's challenging to find asset classes that can offer strong potential returns (like shares) without unacceptable increases to the portfolio's risk of negative returns. Our new defensive Australian shares strategy aims to increase our total exposure to Australian shares – and benefit from the potential returns from this asset class – while carefully controlling the downside risk of these assets.

To include the defensive Australian shares strategy in the MLC Inflation Plus portfolios, we've reduced the allocations to cash and existing Australian shares managers.

Which funds are affected?

These changes affect the MLC Inflation Plus portfolios. [1]

The MLC Horizon portfolios have an indirect allocation to the new strategy through their investment in the MLC Inflation Plus strategies.

How may investors benefit?

We expect the potential benefits of this change to include:

- higher returns above inflation over the long term (due to the increased total allocation to Australian shares), and
- by investing in the defensive Australian shares strategy rather than our other Australian shares managers we have greater ability to limit potential loss of investors' capital in volatile markets.

What is the new strategy?

The defensive Australian shares strategy is managed by our Capital Markets Research (CMR) team. It's an extension of the team's existing capabilities and process for managing our multi-asset portfolios.

[1] All funds affected by these changes are listed in the Important Information section at the end of this document.

Key to the investment process for our multi-asset portfolios is our scenarios-based Investment Futures Framework[2] . It helps us take into account the many scenarios that could unfold, positive and negative, to gain continual insight into potential risks, sources of return, and opportunities for diversification. We use the insights to determine the asset allocations that will help achieve our portfolios' objectives with the right level of risk control.

In our new strategy, we apply these scenario insights to our Australian shares exposures. We believe that creating this strong alignment between our asset allocation insights and decisions about Australian shares sectors and stocks will help us to achieve the real return objective of our Inflation Plus portfolios.

In summary, we employ our scenario insights to determine the allocations to each sector with the aim of controlling risk and then filter out the lower quality stocks (eg those with weak or deteriorating financials). This usually leads to the sector weights being less concentrated than the market. The process employs a blend of quantitative and qualitative inputs. More details are in the 'What is the investment process for the new strategy?' section below.

We've been managing and evolving the strategy since 2012. Over that time it has delivered higher returns when the share market is falling and lower returns when the market is rising. This is the role we expect it to play in the MLC Inflation Plus portfolios.

We also expect the strategy to be less volatile than the share market because of the strategy's lower exposure to stocks that are likely to have significant negative returns.

The defensive Australian shares strategy, like the MLC Inflation Plus portfolios, isn't tied to a share market benchmark. In an adverse market, simply doing better than the benchmark may not be enough to achieve a real return outcome. Because we're not bound by the benchmark, we can reduce or remove exposure to industry sectors that we think have too much downside risk. The way we've dealt with banking stocks in the new strategy is a good example of this.

The Australian share market is one of the most concentrated in the world, with the 'Big Four' banks making up nearly 30% of the ASX/S&P200 Index. Despite the valuation of banks being near historical averages, there are some scenarios in our Investment Futures Framework that are particularly negative for Australia (such as the 'Australian stress' scenario) which would be adverse for the banking sector if these scenarios were to occur. As a result, we didn't include banks in the defensive Australian shares strategy until we felt their valuations better reflected their downside risks.

This is a very different approach to an Australian shares manager whose performance is measured against the market benchmark – they are often forced to include substantial allocations to banks due to their dominant position in the index, regardless of the manager's view of the risk.

Chart 1 shows the strategy's much lower concentration than the S&P/ASX200. The largest 20 companies in the index comprise 61%, yet represent just 18% of the strategy. The top 20 stocks in the portfolio represent 35% of the strategy. The defensive Australian shares strategy's benchmark unaware approach provides much broader diversification across the share market.

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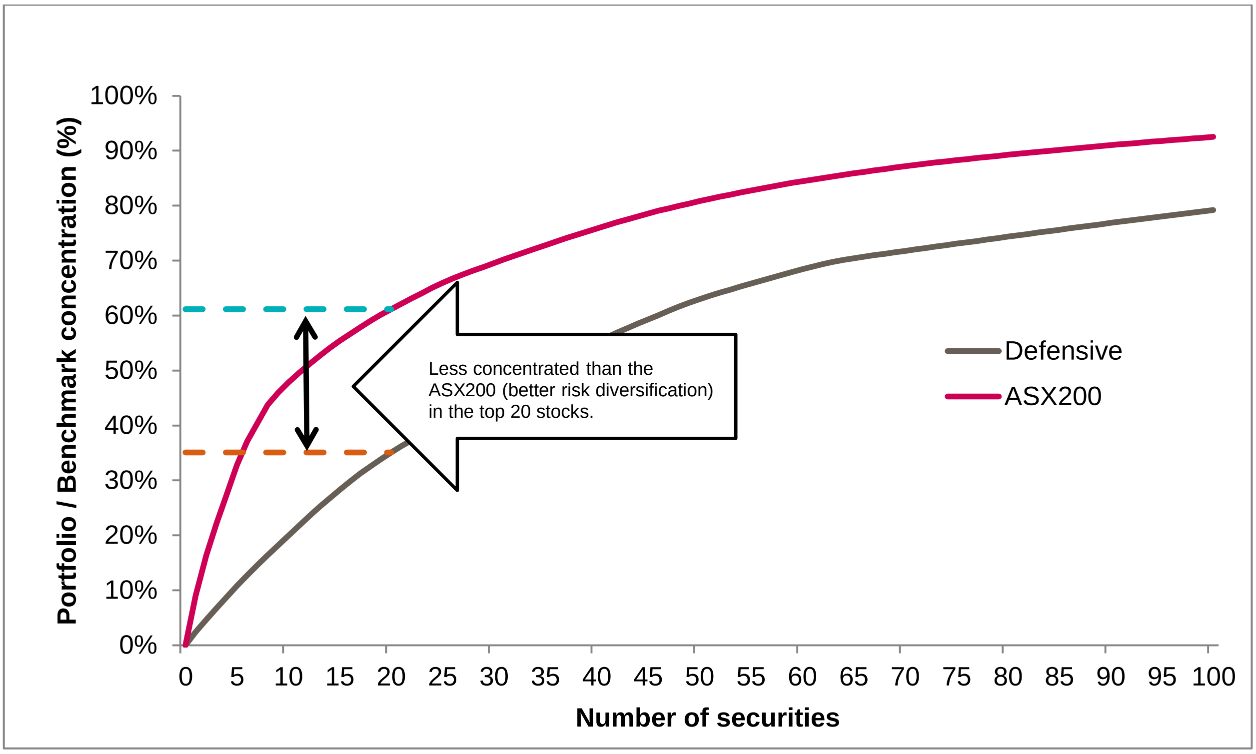
[2] Information on our scenarios-based Investment Futures Framework is available quarterly and is accessible to advisers via '[MLC's scenario insights & portfolio positioning]' paper. The paper details CMR's assessment of the current market environment, risk and return opportunities, scenarios that may play out and how our multi-asset portfolios are positioned.

Chart 1: The defensive Australian shares strategy is less concentrated than the S&P/ASX200



As at 31/10/2016; includes cash holdings. Source: JANA Corporate Investment Services Limited.

Why aren't we using an external manager for the new strategy?

As the CMR team can translate the insights from the Investment Futures Framework directly to the Australian shares exposures, it's much more efficient, reliable and cost-effective to manage the process inhouse.

We've had considerable success using inhouse managers in our multi-asset portfolios when we've been unable to find suitable external managers for particular strategies. For example, we asked Antares Fixed Income to develop tailored strategies for cash, enhanced index and inflation-linked bonds for our multi-asset portfolios as far back as the late 1980s, and we are still using those strategies today.

What is the investment process for the new strategy?

There are three parts in the investment process.

Scenario insights input

This part of the process is the most important as it's when the CMR team is able to shape the risk characteristics of the strategy towards the objectives of the MLC Inflation Plus portfolios. CMR applies macro insights gained from the Investment Futures Framework to define the maximum and minimum weights for the sectors. These weight limits then form the basis for stock specific constraints in the 'optimisation' of portfolio weights (explained below).

Screening

After we define the range of sector weights, we filter the ASX/S&P200 Index universe of stocks. We apply a systematic 'negative selection process', which helps analyse the underlying fundamentals of each stock to filter out the lower quality stocks. This approach of 'avoiding the losers', or eliminating the most risky stocks, is very different to the approach of bottom-up share managers who are trying to 'pick the winners'. This filter generally results in 120 to 150 stocks. We then incorporate any fundamental company insights on factors such as valuations, to determine the final range of potential stock weights.

Optimisation

The final part of the process is a constrained optimisation (using Barra analytical tools), with our goal being to minimise the total risk of the portfolio. Here we apply the sector and stock-specific weights from the 'scenario insights input' and 'screening' elements outlined above. These weights are applied not only to incorporate our macro-economic risk considerations, but also to avoid the concentration of stocks within a sector. The outcome is a portfolio typically comprising of between approximately 50 and 150 securities, depending on the investment environment.

While the strategy is formally rebalanced and reviewed each quarter, it is monitored continually so that adjustments to the portfolio or process can be made in response to large market moves, macro news and stock specific events.

In terms of the final portfolio, key risk constraints include:

- a minimum of 20 securities (could be a stock or an exchange traded fund, ETF), with a 10% maximum weight in any one security.
- a maximum cash position of 50% (currently 20%). This large potential cash position allows the implementation of asset allocation decisions quickly within the portfolio.

Overall, the portfolio tends to have lower absolute volatility than the S&P/ASX200 Index. However, given it is benchmark unaware it tends to have a significantly higher tracking error, a mid and small cap bias, and much higher active share[3] than traditional Australian active managers. Its active share tends to be similar to global active managers. Portfolio turnover has been around 40% pa.

What are the new allocations?

Table 1 shows the new shares and cash allocations in the MLC Inflation Plus portfolios. A complete list of the portfolios affected by the new strategy allocations is in the Important Information section at the end of this document.

Table 1: New allocations in the MLC Inflation Plus portfolios

	MLC MasterKey Super & Pension Fundamentals			MLC Wholesale, MLC MasterKey Unit Trust, MLC MasterKey Investment Service/Fundamentals and MLC Wrap		
Asset class	**MLC Inflation Plus Conservative**	**MLC Inflation Plus Moderate**	**MLC Inflation Plus Assertive**	**MLC Inflation Plus Conservative**	**MLC Inflation Plus Moderate**	**MLC Inflation Plus Assertive**
	% (change)	% (change)	% (change)	% (change)	% (change)	% (change)
Australian shares	0.0	2.0 **(-1.0)**	2.0 **(-2.0)**	0.0	2.0 **(-1.0)**	2.0 **(-2.0)**
Defensive Australian shares	2.0 **(+2.0)**	2.0 **(+2.0)**	3.0 **(+3.0)**	2.0 **(+2.0)**	2.0 **(+2.0)**	3.0 **(+3.0)**
Defensive global shares (unhedged)	12.0	20.0	37.5	13.0	22.0	42.5
Global shares (hedged)	0.0 **(-0.5)**	0.0 **(-0.5)**	0.0	0.0	0.0	0.0

[3] Active share is a measure of the extent of a manager's active positions relative to its benchmark.

Emerging markets strategy (unhedged)	1.0	2.0	4.0	1.0	2.0	4.0
Enhanced cash	29.0 **(-1.5)**	17.0 **(-0.5)**	10.0 **(-1.0)**	29.0 **(-2.0)**	15.5 **(-1.0)**	10.0 **(-1.0)**
Australian non-government bonds (short maturity)	27.0	20.0	2.0	26.0	20.0	0.0
Australian inflation-linked bonds	6.0	5.0	4.0	6.0	5.0	4.0
Global bank loans (hedged)	4.0	4.0	4.0	5.0	5.0	4.0
Insurance-related investments (hedged)	0.0	2.0	2.0	0.0	2.0	2.0
Low correlation strategy	6.0	8.0	8.0	6.0	8.0	8.0
Multi-asset real return strategy (hedged)	9.0	11.0	14.0	10.0	13.5	16.0
Risk management strategy	2.0	3.0	4.5	2.0	3.0	4.5
Global private assets	2.0	4.0	5.0	0.0	0.0	0.0
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

Figures are rounded to one decimal place.

The current manager allocations for our funds are available on the Fund Profile Tool on mlc.com.au/fundprofiletool

Are there fee implications?

There are no changes to fees as a result of this strategy change.

Investment fees are available in the Fund Profile Tool on mlc.com.au and mlcinvestmenttrust.com.au. For further information regarding fees please refer to the relevant product PDS.

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The funds affected by these changes

The following funds are affected by the changes to the Australian share strategy in the MLC Inflation Plus portfolios. These funds are offered through MLC's platforms and MLC Wholesale, in addition to some external platforms.

MLC Inflation Plus Conservative Portfolio

MLC Inflation Plus Moderate Portfolio

MLC Inflation Plus Assertive Portfolio

MLC Wholesale Inflation Plus Conservative Portfolio

MLC Wholesale Inflation Plus Moderate Portfolio

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